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No. 80-1251

In the Supreme Court of the United States

October Term, 1980

UNITED STATES OF AMERICA,
Petitioner,

v.

VOGEL FERTILIZER COMPANY,
Respondent.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF CLAIMS

BRIEF FOR VOGEL FERTILIZER COMPANY

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THE QUESTION PRESENTED FOR REVIEW

The question presented for review is whether Vogel Fertilizer Company, the Respondent, and Vogel Popcorn Company must be considered as a "brother-sister controlled group" under Section 1563(a)(2) of the Internal Revenue Code of 1954 (26 U.S.C.) for purposes of limiting or denying, as the case may be, to Vogel Fertilizer Company the full corporate surtax exemption otherwise available under Section 11(d).

This question is in turn dependent upon whether a person's stock ownership can be considered for purposes of the 80-percent test under Section 1563(a)(2)(A) when that person does not own stock in each corporation comprising the alleged brother-sister controlled group. The resolution of this question is directly dependent upon whether Treas. Reg. § 1.1563-1(a)(3) is valid despite its effect of unilaterally and unreasonably expanding the scope of Section 1563 beyond that intended by Congress.

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STATUTE AND REGULATIONS

The relevant portions of Sections 11(d), 1561(a), 1562, 1563(a)(2), and 1564(a) of the Internal Revenue Code of 1954 (26 U.S.C.),[1] and of Treasury Regulation, Section 1.1563-1(a)(1) and (3), and Section 1.1551-1(e)(1) and (3) (26 C.F.R.), are set forth in the Appendix, *infra*, 1a-10a.

STATEMENT OF THE CASE

1. Respondent Vogel Fertilizer Company ("VFC"), an Iowa corporation with offices and principal place of business located in Hamburg, Iowa, sells agricultural fertilizer products at retail to local customers. For all relevant periods of time, all of the issued and outstanding stock in VFC was held by the following persons in the amounts and percentages as indicated opposite each name:

Vogel Fertilizer Company

Common Stock Owner	No. of Shares	Percent
Arthur Vogel	113,575	77.49%
Richard Crain	33,000	22.51%
	146,575	100.00%

VFC had no preferred stock or other class or classes of stock authorized or issued. (Pet. App. 2a).

2. Vogel Popcorn Company ("VPC"), an Iowa corporation with offices and principal place of business also located in Hamburg, Iowa, is engaged in the business of wholesaling and retailing popcorn. For all relevant periods of time, all of the issued and outstanding stock in VPC was held by the following shareholders in the amounts and percentages indicated opposite each name:

---

1 Unless otherwise noted, the Internal Revenue Code of 1954 (26 U.S.C.) will hereinafter be referred to as "IRC."

Vogel Popcorn Company

Shareholder	No. of Shares	Voting % of All Classes Entitled to Vote	Percent of Value of All Classes of Stock 1973	1974	1975
Arthur Vogel	440,062 Common Stock	87.5%	90.66%	91.42%	93.42%
Arthur Vogel, Trustee of Alex Vogel Family Trust	62,866 Voting Preferred Stock, $1 Par	12.5%	9.34%	8.58%	6.58%

VPC had no other stock authorized or issued. (Pet. App. 2a).

3. For purposes of this case, the stock held by either Richard Crain and Arthur Vogel in VFC cannot be attributed to the other under the attribution rules of IRC § 1563(d). Furthermore, and under the same rules of attribution, Arthur Vogel, as an individual, cannot be considered as the constructive owner of the VPC shares held by him as Trustee. (Pet. App. 2a).

4. VFC's original tax returns were filed based on the incorrect assumption that VFC and VPC constituted a brother-sister controlled group of corporations, a conclusion required under the applicable Treasury Regulations. Treas. Reg. § 1.1563-1(a)(3). Therefore, on its original returns VFC did not utilize a full surtax exemption, but rather elected for 1973 and 1974 to utilize the multiple surtax penalty (IRC §§ 1562 and 1564(a)) and the multiple surtax penalty (IRC § 1562(b)). For 1975, VFC elected to utilize a "shared" surtax exemption ("shared" with VPC by VPC taking the entire surtax exemption, pursuant to IRC § 1561(a)(2)). (Pet. App. 2a-3a).

5. On January 26, 1976 (after VFC had filed its returns for the years in question), the United States Tax Court filed its decision in *Fairfax Auto Parts of Northern Virginia, Inc. v. Commissioner*, 65 T.C. 798 (1976), *rev'd per curiam*, 548 F.2d 501 (4th Cir. 1977),

cert. denied, 434 U.S. 904 (1977) [hereinafter cited as *Fairfax*]. In *Fairfax*, the Tax Court held in a case of first impression that Treas. Reg. 1.1563-1(a)(3) constituted "a totally unwarranted extension of both the statutory language of Section 1563(a)(2) and the underlying congressional intent," and as such was invalid. *Fairfax*, 65 T.C. at 802-803. Based on this then-new authority, VFC subsequently filed timely claims for refund. VFC asserted in its claims for refund that it and VPC were not members of a controlled group of corporations, and that therefore VFC was entitled to a full surtax exemption for each taxable year. After the Internal Revenue Service disallowed VFC's claims because of Treas. Reg. § 1.1563-1(a)(3) despite the holding in *Fairfax*, VFC commenced this refund lawsuit in the United States Court of Claims. (Pet. App, 3a).

6. The United States Court of Claims, with a dissenting opinion, agreed that VFC should be entitled to a separate surtax exemption, holding Treas. Reg. § 1.1563-1(a)(3) "invalid to the extent that it counts stock held by a shareholder in only one corporation of the group of corporations toward the 80-percent requirement in Section 1563(a)(2)(A)." (Pet. App. 34a).

SUMMARY OF ARGUMENT

1. The Court of Claims has correctly determined that Vogel Fertilizer Company and Vogel Popcorn Company are not members of a "brother-sister controlled group" under IRC § 1563(a), and that Vogel Fertilizer Company is therefore entitled to a full surtax exemption for each of the years in question. The Court of Claims reached this result by determining that Richard Crain's stock ownership in Vogel Fertilizer Company could not be counted for purposes of the 80-percent test of IRC § 1563(a)(2)(A), since he did not have any interest in Vogel Popcorn Company. Under this interpretation of the 80-percent test, the 77.49% stockholdings of the remaining shareholder (Arthur Vogel) were not sufficient to satisfy the 80-percent test. Thus, the two corporations

could not be deemed members of a controlled group of corporations under IRC § 1561.

2. The issue is whether the 80-percent test of IRC § 1563(a)(2) requires a person to have an ownership interest in each member of the alleged brother-sister controlled group before his stock ownership can be counted for purposes of that test, i.e., the principle of common ownership. The conclusion reached by the Court of Claims, Fifth Circuit (*Delta Metalforming Co., Inc. v. Commissioner, 632 F.2d 442 (5th Cir. 1980), cert. pending* No. 80-1499 (filed March 4, 1981) [hereinafter cited as *Delta Metalforming*]), and Tax Court (*Fairfax*) that the principle of common ownership *is* applicable under the 80-percent test of IRC § 1563(a)(2), and that the rule to the contrary in Treas. Reg. § 1.1563-1(a)(3) is to that extent invalid as an "unreasonable and inconsistent" regulation, is supported by the legislative history and purpose of the statute.

The original purpose of the surtax exemption enacted in 1950 was to reduce the tax burden on small businesses. IRC § 1563(a)(2) was enacted in 1964, and amended in 1969, to meet the specifically perceived problem of large corporations subdividing into several smaller, but still integrated, corporations simply to obtain a lower effective tax rate because of the availability of multiple exemptions by such action. The purpose behind IRC § 1563(a)(2), then, was to design a statutory scheme which both identified the "small" corporations which were actually components of much larger business units, while still affording the benefit of the surtax exemption to those "bona fide" small businesses that Congress always intended to benefit and stimulate. This design can only be carried out if (contrary to the Government's position) the principle of common ownership is part of the 80-percent test, since the only means of discovering the links between the subdivided portions of the large entity is by means of the financial interest the "large entity" has in the smaller parts of the whole. Since an individual can only have a financial

interest in a corporation if he owns stock therein, to take into consideration under the 80-percent test an individual who does not own stock in each member of the alleged control group defeats this statutory design of Congress.

That the mere expansion of the ownership group from one (in the 1964 version of the statute) to five was not intended to have the effect of abandoning the common ownership or financial interest principle, as the Government argues, is implicit from an examination of the transition of the Government's interpretation of the 80-percent test from enactment in 1964 to amendment in 1969. The original 80-percent test was recognized even by the Government to require common ownership. If the Government had interpreted the original test otherwise, as it now urges the current test to be interpreted, a ludicrous situation would have resulted where all existing corporations with sole shareholders would have been combined into one gigantic controlled group. With the drafting of Treas. Reg. § 1.1563-1(a)(3), the Government abandoned the principle of common ownership. However, there is nothing in the history of the 1969 amendment to show that this major change was intended. All that was changed in the 80-percent test was to increase the ownership group from one to five. Logically, this change should not have affected the application of the principle of common ownership as it had been applied since 1964. If Congress had meant to abandon this key principle in 1969, it surely would have indicated such in unmistakable terms. It did not, however, and therefore the regulation is clearly excessive in bringing to bear a rule change never contemplated by Congress.

Indeed, the only available contemporaneous explanation of the 1969 amendments to IRC § 1563(a)(2), the Treasury's own carefully considered "General Explanation" and "Technical Explanation" (upon which Congress placed great reliance) confirms that a financial interest by each person in the "five or fewer" group

was required before they could be included in the 80-percent test. Among other items, the very wording of the explanation by the Treasury, plus the fact that no example was provided similar to that in Treas. Reg. § 1.1563-1(a)(3) to illustrate what would have been a significant change in the scope of the law, seriously undermines the Government's position.

Thus, it is submitted that Congress intended that the purpose of the 80-percent test was to require an aggregate ownership which represented substantially the entire financial interest of all involved corporations. The purpose of the 50-percent test, which is secondary to the 80-percent test, was to permit corporations with widely differing holdings of stock to fall outside the controlled group, since such a situation would make it difficult to effectively control the corporations as one. The Government's interpretation set forth in Treas. Reg. § 1.1563-1(a)(3), however, renders the 80-percent test irrelevant. If control is found under the 50-percent test, what does the Government's requirement that an additional 30 percent of control be owned by someone else really add? Congress could just as well have then had only one test, rather than the two it provided. Such an interpretation does not give the 80-percent test the status intended by Congress, and as such the Regulation is clearly unreasonable and inconsistent with Congressional intent. Only when the 80-percent test is viewed as a measure of financial interest do *both* tests become meaningful, one measuring control and one measuring the level of financial interest.

Equitable considerations also exist to indicate that the interpretation of the 80-percent test in Treas. Reg. § 1.1563-1(a)(3) is incorrect. Let us suppose that two individuals formed a corporation, with individual A owning 50 percent and B owning 50 percent. Individual B would have entered into this arrangement assuming that the corporation would have the benefit of the surtax exemption. However, unbeknown to B, individual A subsequently and independently creates a second cor-

poration, 100 percent owned by A, in order to enter into a second business. Under the Government's interpretation of IRC § 1563(a)(2), the full surtax exemption is lost to the first corporation and B, a result not reached under the Court of Claims' rationale. Surely Congress did not intend that such an unfair surprise be visited upon individual B, i.e., Richard Crain, under what must be a common fact pattern, because of actions taken by an individual over whom he has no control. Thus, it is all the more clear that the Government's interpretation of IRC § 1563(a)(2) is unreasonable and inconsistent with Congressional intent.

3. IRC § 1563(a)(2) sets forth the definition of a "brother-sister controlled group" as any group of:

> "[T]wo or more corporations if *5 or fewer persons* . . . own . . . stock possessing —
>
> (A) at least 80 percent of the . . . stock of each corporation, *and*
>
> (B) more than 50 percent of the . . . stock of each corporation, taking into account the stock ownership of *each such person* only to the extent such stock ownership is identical with respect to each such corporation." (Emphasis added).

When the significant words of IRC § 1563(a)(2) are analyzed using well-established and commonly used guidelines of English grammar and usage, the conclusion reached is that the Tax Court (*Fairfax*), Fifth Circuit (*Delta Metalforming*), and the Court of Claims herein were correct in requiring for purposes of the 80-percent test the principle of common ownership. First, the statutory phrase "five or fewer persons" is the conjunctive subject of both the 80- and 50-percent tests. In order to be considered part of the ownership group for the 50-percent test, one must own stock in each corporation involved. "If ownership of stock in each corporation involved is a precondition to membership in the owner-

ship group for purposes of the 50-percent test, and the ownership groups for the 50-percent test and 80-percent test are one and the same, it follows . . . that one must own stock in each corporation before his stock can be taken into account for purposes of the 80-percent test." *Fairfax*, 65 T.C. at 803 (1976).

Second, the "last antecedent doctrine" establishes that the clause "each such person" under the 50-percent test directly refers back to the same "5 or fewer persons" being reviewed under the 80-percent test. The use of term "each" [such person] must mean that "each person — and not just some of the persons — counted for purposes of the 80-percent test must also be counted for purposes of the 50-percent test." *Fairfax*, 65 T.C. at 803 (1976). Moreover, the commonly understood definitions of the particular statutory terminology used in IRC § 1563(a)(2) support a reading that requires the principle of common ownership under the 80-percent test. The very title and subtitles of the statute "contemplates a relationship of close ties and common connections . . . ." and "underscore the common connections, interrelationships and mutual influences of the group." *Delta Metalforming*, 632 F.2d at 446.

Thus, the result obtained to the contrary by the Government's "natural reading" theory of statutory construction (and the interpretation of IRC § 1563(a)(2) advanced by Treas. Reg. § 1.1563-1(a)(3)) is erroneous and plainly inconsistent with the statutory language of IRC § 1563(a)(2). It can only be assumed that Congress intended to follow the rules of good grammar and English usage when drafting IRC § 1563. Therefore, the result obtained from the application of such rules, that is, the requirement of common ownership under the 80-percent test, must be the result intended by Congress.

4. The principle of deference to the regulatory efforts of the Commissioner is designed so as "to set the framework for judicial analysis: it does not displace it." *United States v. Cartwright*, 411 U.S. 546 at 551 (1973). Where a

regulation, as here, is clearly unreasonable and "creates a rule out of harmony with the statute . . . ," it must be held invalid, as the Court of Claims recognized. *Manhattan General Equipment Co. v. Commissioner*, 297 U.S. 129, 134 (1936). Simply "because [the Commissioner] has a choice of alternatives, his choice should [not] be sustained where the alternative chosen is unrealistic." *United States v. Cartwright*, 411 U.S. *supra* at 557. The Commissioner cannot be allowed to rewrite, add to, and expand the statute beyond that intended by Congress, as he has attempted in Treas. Reg. § 1.1563-1 (a)(3). *United States v. Calamaro*, 345 U.S. 351 (1957).

Accordingly, since Treas. Reg. § 1.1563-1(a)(3) has been shown to be unreasonable, inconsistent with the intent of Congress, and outside the authority of the Commissioner, the normal policy of "deference" is not appropriate. Treas. Reg. § 1.1563-1(a)(3) simply is not worthy of the respect usually so granted to the Commissioner's regulations.

ARGUMENT

For a person's stock ownership to be taken into account for purposes of the 80-percent test of Section 1563(a)(2)(A), that person must own stock in each member of the alleged brother-sister controlled group. Since Treas. Reg. § 1.1563-1(a)(3) clearly advances a contrary rule, it is invalid as an impermissible and unreasonable expansion of the statute beyond that intended by Congress.

The legal question presented by this case is whether Vogel Fertilizer Company (hereinafter "VFC") and Vogel Popcorn Company (hereinafter "VPC") may be considered a "brother-sister controlled group" under IRC § 1563(a)(2). If VFC and VPC are not members of such a controlled group, as the Court of Claims found, then it is undisputed that VFC is entitled to a full surtax exemption for each taxable year in question, as as-

serted in the claims for refund filed by VFC.[2]

A. The Treasury Regulation is inconsistent with the intent of Congress, and is a clearly unreasonable interpretation of Section 1563(a)(2) when the legislative history and purpose of the statute is considered.

1. IRC § 1563(a)(2) defines a "brother-sister controlled group" of corporations as any group of:

> "Two or more corporations if 5 or fewer persons who are individuals, estates, or trusts own (within the meaning of subsection (d)(2)) stock possessing —
>
> (A) at least 80 percent of the total combined voting power of all classes of stock entitled to vote or at least 80 percent of the total value of shares of all classes of the stock of each corporation, and
>
> (B) more than 50 percent of the total combined voting power of all classes of stock entitled to vote or more than 50 percent of the total value of shares of all classes of stock of each cor-

2 The legal question arises from the corporate income tax provisions of the Internal Revenue Code of 1954. During the taxable years in question, a corporation's income tax was equal to the sum of a "normal tax" (IRC § 11(b)) and a "surtax" computed under IRC § 11(c). The surtax for the years in question was equal to 26 percent of the amount by which corporate taxable income exceeded a "surtax exemption" for the taxable year. IRC § 11(c). For VFC's taxable years ending in November 30, 1973 and 1974, the surtax exemption was $25,000; for the year ending November 30, 1975, the surtax exemption was $50,000. IRC § 11(d), as amended by Tax Reform Act of 1969, Pub. L. No. 91-172, Section 401(b)(2)(B), 83 Stat. 602, and as amended by Tax Reduction Act of 1975, Pub. L. No. 94-12, Section 303(b), 89 Stat. 26. If a corporation was determined to be a member of a controlled group of corporations, then as a general rule the surtax exemption for that corporation was equal to a particular share of a single surtax exemption. This share was established either by agreement among the members of the controlled group, or was an equal share

> poration, taking into account the stock ownership of each such person only to the extent such stock ownership is identical with respect to each such corporation."

Thus, two separate tests, i.e., a "50-percent identical interest-control test" and an 80-percent "financial interest test," must both be met before a corporation will be included within the definition of a brother-sister controlled group.

Under IRC § 1563(a)(2)(B), the 50-percent test is met when the stockholdings in VFC and VPC of one stockholder, Arthur Vogel, are considered:

VFC and VPC 50-Percent
Identical Interest Test

	VFC	VPC	Identical Interest
Arthur Vogel	77.49%	87.5%	77.49%
Arthur Vogel, Trustee	0%	12.5%	0%
Richard Crain	22.51%	0%	0%
Total Identical Interest:			77.49%

To qualify VFC and VPC as a brother-sister controlled group, however, the 80-percent test must also be satisfied. The question presented for review, and the source of the dispute between VFC and the Government, is in the application of the 80-percent test to the stockholdings of VFC and VPC. More specifically, the

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of the exemption as divided among the entire group. IRC § 1561. During 1973 and 1974, however, members of a controlled group could, at their option, elect "multiple surtax exemption" treatment. IRC § 1562. (VFC made such an election in 1973 and 1974.) This meant, in effect, that a corporation, even though a member of a controlled group, could elect to utilize an entire single surtax exemption in computing its tax, but with the proviso that a "penalty" equal to 6 percent of its first $25,000 of taxable income would be added to its income tax. For 1973, the maximum allowable surtax exemption under the multiple surtax exemption was $12,500; in 1974, the multiple surtax exemption was $8,333. IRC § 1564(a)(1).

question is whether Richard Crain's stock ownership can be taken into account during the process of finding the "5 or fewer persons" who own 80 percent of VFC, when he does not have any ownership interests in VPC.[3] The Government would count Mr. Crain's stock on the basis of its Regulation, while VFC would not. These contrasting positions are illustrated by the following tables:

VFC's Application of 80-Percent Test
(Percentage of Voting Stock Owned)

	Arthur Vogel	Arthur Vogel, Trustee	Richard Crain	Total Ownership of Stockholders Owning Stock in Both Corporations
VFC	77.49%	0%	22.51%	77.49% (80% test *not* satisfied)
VPC	87.5 %	12.5%	0%	87.5 %

Government's Position, 80-Percent Test
(Percentage of Voting Stock Owned)

	VFC	VPC
Arthur Vogel	77.49%	87.5%
Arthur Vogel, Trustee	0%	12.5%
Richard Crain	22.51%	0%
80-Percent Test:	100.00%	100.0%

2. There is no doubt that the Treasury Regulation comes to a conclusion contrary to VFC's interpreta-

3 The question at issue herein has been the topic of considerable litigation, the result of which is that the Tax Court, Court of Claims, and Fifth Circuit have all held that Treas. Reg. § 1.1563-1 (a)(3) is invalid and that a person must own stock in each corporation to be counted under the 80-percent test. Three Circuit Courts of Appeal, however, have held to the contrary, i.e., the Fourth Circuit, Second Circuit, and Eighth Circuit. *See, e.g., Fairfax Auto Parts of Northern Virginia, Inc. v. Commissioner*, 65 T.C. 798 (1976), *rev'd per curiam*, 548 F.2d 501 (4th Cir. 1977), *cert. denied*, 434 U.S. 904 (1977); *T. L. Hunt, Inc., of Texas v. Commissioner*, T.C.M. (CCH) 1976-221 (1976), *rev'd*, 562 F.2d 532 (8th Cir. 1977); *Charles Baloian Company, Inc. v. Commissioner*, 68 T.C. 620 (1977), *appeal pending* (9th Cir. 1978); *Delta Metalforming Co., Inc. v. Commissioner*, T.C.M. (CCH) 1978-354 (1978), *aff'd* 632 F.2d 442 (5th Cir. 1980); *Allen Oil Company, Inc. v. Com-*

tion of the statute. There is also no doubt that the Government places great reliance upon that conclusion (self-serving though it may be in view of the fact that the Government has created its own "authority" by drafting the regulation). The Court of Claims, however, found the Government's reliance on Treas. Reg. § 1.1563-1 (a)(3) to be misplaced, as the regulation was "clearly inconsistent with the legislative history and unreasonable when the purpose, as well as the bare words, of the statute are considered." (Pet. App. 12a and 28a). *See also, Fairfax*, 65 T.C. 798 (1976); *Delta Metalforming*, 632 F.2d 442 (5th Cir. 1980). If the Court of Claims, Tax Court, and Fifth Circuit are correct, as VFC believes is the case, and the Regulation is invalid, then the Government's statutory analysis must also be invalid, as the two go hand-in-hand in stating the same rule.

Treas. Reg. § 1.1563-1(a)(3) defines a "brother-sister controlled group" in a manner significantly different from the language of IRC § 1563(a)(2) by adding the words "singly or in combination" to the statutory definition.[4] Under the Regulation, a brother-

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missioner, T.C.M. (CCH) 1979-88 (1979), *rev'd*, 614 F.2d 336 (2nd Cir. 1980); *Davidson Chevrolet Co. and Monte Zinn Chevrolet Co.*, T.C.M. (CCH) 1979-414 (1979), *appeal pending* (6th Cir. 1980); *Jacqueline, Inc. v. Commissioner*, T.C.M. (CCH) 1977-340 (1977). Indeed, even where the Tax Court is bound by the *Golsen* rule (requiring it, by its own rules, to follow precedent established by the Circuit Court of Appeals to whom a case would be appealed, *Golsen v. Commissioner*, 54 T.C. 742 (1970), the Tax Court maintains that Treas. Reg. § 1.1563-1(a)(3) is invalid. *See, e.g., Dixie Realty Co., Inc.*, T.C.M. (CCH) 1980-297 (1980).

4 It is interesting to note the ease with which the Treasury modified the statutory language of IRC § 1563(a)(2) to clearly indicate that the principle of common ownership should not be a part of the 80-percent test. The very ease of this modification, i.e., the addition of only four words to the statute, indicates that if Congress had intended to so eliminate the requirement of common ownership from the 80-percent test, it certainly could have easily and clearly done so. The fact that Congress did

sister controlled group exists where there are two or more corporations if:

> "... the same five or fewer persons ... own ... *singly or in combination*, stock possessing —
>
> (a) At least 80 percent of the total combined voting power of all classes of stock entitled to vote or at least 80 percent of the total value of shares of all classes of the stock of each corporation; and
>
> (b) More than 50 percent of the total combined voting power of all classes of stock entitled to vote or more than 50 percent of the total value of shares of all classes of stock of each corporation, taking into account the stock ownership of each such person only to the extent such stock ownership is identical with respect to each such corporation." (Emphasis added). Treas. Reg. § 1.1563-1(a)(3).

Example 1 of the Regulation further illustrates the Treasury's belief that the 80-percent test does not require common ownership of stock in each corporation, and would therefore require Richard Crain's stockholdings in VFC be counted toward that test, even though he does not have any interest in VPC. Treas. Reg. § 1.1563-1(a)(3)(ii).

It is clear that the Regulation represents a totally

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not take such a step was recognized by the Fifth Circuit as an important factor:

> "Further, if Congress had intended to change the requirement of sameness or common ownership, it certainly knew how to do so. See Thomas, 28 Tax L. Rev. at 79 ('One thing is certain: If Congress had intended the interpretation adopted by the regulation, it could have drafted a statute which stated it more accurately.). Indeed, it seems to us that the Treasury — who originally endorsed the 1969 amendment and on whom congressional committees extensively rely — would have suggested language (such as that used in their subsequent corollary regulation) had it intended to reject the common ownership requirement." *Delta Metalforming*, 632 F.2d at 448.

impermissible construction of the statutory language when an analysis is made of the transition of the interpretation of the 80-percent test from enactment in 1964 through amendment in 1969. Prior to amendment by the Tax Reform Act of 1969, there is no doubt that IRC § 1563(a)(2) was written and interpreted by the Government so as to apply only in those situations where at least 80-percent of *each* corporation in the brother-sister controlled group was owned by the *same one person*, i.e., the principle of common ownership. IRC § 1563(a)(2) (as added by Revenue Act of 1964, Pub. L. 88-272, § 235(a), 78 Stat. 19). (See Appendix, *infra.*). (If the Government *had* interpreted the 1964 version in the manner it is urging that the present 80-percent test should be interpreted, that is, absent the principle of common ownership, it would have resulted in the ludicrous situation of combining all existing corporations with sole shareholders into one gigantic controlled group.) In 1969, even the Government recognizes that the *only* change made to the 80-percent test was to expand the group of one to a maximum of five. No other change was made or implied to the 80-percent test. Logically, and absent any indication to the contrary by Congress, the mere increase in the size of the ownership group should not have therefore affected the continued application of the principle of common ownership. This can then only be taken as authority for now permitting the 80-percent test to be satisfied only where the now larger number of the same persons comprise the ownership group of, and have interests in, each corporation. Treas. Reg. § 1.1563-1(a)(3) clearly exceeds that authority.

As support for this conclusion, it should be pointed out that the Government certainly has not been able to demonstrate, and cannot demonstrate, that Congress ever intended to abandon the requirement present in the 1964 statute that the individuals in control must have a financial interest in *each* corporation when it expanded the ownership group from the one required in the old version to the five required now. The Fifth Circuit's reasoning on this point is particularly persuasive:

> "*There is nothing in the legislative history to suggest that the kind of group which would and would not be entitled to the exemption — the 'sameness' — was to be altered.* Absent a clear indication to the contrary, it is reasonable to assume that the persons within the control group would continue to constitute the ownership group of each corporation. The House and Senate Reports do not indicate any intention to change the constituents of the ownership group. Indeed, all of the examples submitted to Congress by the Treasury to illustrate the operation of the exemption involve shareholders who own stock in each corporation. *The absence of contrary examples strongly suggest that the Treasury did not contemplate the definition of the 80% test group by strangers to the 50% test group.*" *Delta Metalforming*, 632 F.2d at 448. (Emphasis added).

See also, T. L. Hunt, Inc. v. Commissioner, supra, 562 F.2d at 537 (Webster, J., dissenting); Libin and Abramowitz, *Multiple Corporations: A Surprising Interpretation of Sec. 1563(a)(2) in Temporary Regulations*, 3 *TAX ADVISER* 326 (1971).

Indeed, as suggested by the Fifth Circuit and more fully explained by the Court of Claims, the Treasury's own carefully considered explanation of the change ultimately put into law by the Tax Reform Act of 1969 confirms that a financial interest by each of the "five or fewer persons" in each corporation was to remain a requirement. The Court of Claims, after a full and exhaustive analysis of the entire General Explanation and the Technical Explanation, discarded any attempt by the Government to argue to the contrary, as the Government is attempting to argue with this Court. The Court of Claims set forth in full the entire relevant portions of the Treasury's Technical Explanation and General Explanation, and discussed in detail how the Treasury's own contemporaneous explanation "clearly indicates that each of the five or fewer persons considered under the 80-percent test must hold some stock in each corpora-

tion in the controlled group." (Pet. App. 21a).

The Court of Claims found as most important in such analysis the particular wording used by the Treasury in describing the change in the 80-percent test (Pet. App. 21a, fn omitted):

> "First and foremost, the Treasury explanation directly states this very proposition:
>
> > ***Under the proposal, the present definition would be changed so that a group of corporations would constitute a brother-sister controlled group if (1) the *same five* or fewer persons own at least 80 percent of the voting stock or value of shares of *each* corporation, and (2) *these* five or fewer individuals own more than 50 percent of the voting power or value of shares of *each* corporation considering a particular person's stock only to the extent that it is owned identically with respect to each corporation. [Emphasis added in part.]
>
> "The use of the word 'same' in the above sentence removes any possible ambiguity and establishes that the same persons must own some stock in each corporation. Moreover, the use of the words 'these five or fewer individuals' supports the construction of the statute by the Tax Court in *Fairfax Auto Parts* to the effect that the same persons, with no additions or subtractions, must be considered in both the 80-percent and the 50-percent tests." [Emphasis original].

The Court of Claims also noted the lack of examples that would have illustrated the removal of the requirement of sameness in the 80-percent test as a factor undermining the Government's arguments (Pet. App. 22a-23a, fn omitted):

> "Moreover, if the Treasury was indeed proposing to remove the requirement of sameness in the 80-percent test, it is scarcely credible that an example to

> illustrate this important change would not have been given. In every example in the Treasury explanation involving the 80-percent test, the persons mentioned own some stock in each corporation. The explanation even states in detail that the 80-percent test is met 'whether one person owns 80 percent of the voting stock of each corporation, four persons *each* own 20 percent of the voting stock of each corporation, or one person owns 60 percent of the voting stock of one corporation *and 40 percent of another*, and another person owns 40 percent of the voting stock of the first *and 60 percent of the second*.' [Emphasis supplied.]"

The Court of Claims ended its persuasive analysis of the Treasury's Explanation by noting that the 80-percent test was envisioned in the Explanation, contrary to the Government's current position, as "a test of independent significance, in fact a test of greater significance than the 50-percent test." (Pet. App. 23a):

> "The explanation states in two places that the 50-percent test is added to 'insure' that the corporations are in fact 'controlled' by the group of stockholders as one economic entity or enterprise. The use of the word 'insure' indicates that the 80-percent test also measures to some degree whether the corporations can be considered one economic entity. The 80-percent test therefore must measure substantial overlapping financial interests. The 50-percent test was added to 'insure,' not to establish, the unity of economic enterprise by measuring whether overlapping control exists.
>
> "Similarly, the explanation states: 'Thus, even where the 80 percent ownership test is met, the brother-sister definition will not apply unless the stockholdings of the individuals in the various corporations also meet the 50-percent identical ownership test.' The emphasis of the sentence on the 80-percent test as the primary requirement belies

> the notion that the 80-percent test was intended to measure only the number of stockholders and not the extent of overlapping stock ownership. The Treasury explanation is totally inconsistent with the relatively minor role relegated to the 80-percent test by Treas. Reg. § 1.1563-1(a)(3)."

The Court of Claims concluded (Pet. App. 24a):

> "In conclusion, we find no ambiguity whatsoever in the Treasury explanation and other legislative material when they are read in their entirety. It would be a gross usurpation of the power of Congress to draft tax statutes to allow the Treasury to explain a legislative proposal in one way and then to interpret it after enactment in a far more expansive fashion."

This analysis, it is submitted, is persuasive, and illustrates why the Government has difficulty rebutting it in their arguments on this point. *See, e.g., Petitioner's Brief* at p. 27-31.

Furthermore, since the single individual under the original definition of IRC § 1563(a)(2) could have controlled for most business purposes each corporation in the brother-sister group with simply a 50-percent ownership of each corporation's stock, Congress, it seems, must have been striving after something more than the simple control (or, as the Government describes it, "closely held") test when it adopted the present-day 80-percent test. *See*, Thomas, *Brother-Sister Multiple Corporations — the Tax Reform Act of 1969 Reformed by Regulation, 28 TAX L. REV.* 65, at 79-83. The 80-percent test, it is submitted, was designed to require an aggregate ownership which represents substantially the entire *financial* interest in all corporations involved. *See, T. L. Hunt, Inc. v. Commissioner*, 562 F.2d 532, 537 (8th Cir. 1977) (Webster, J., dissenting); Thomas, *Brother-Sister Multiple Corporations — the Tax Reform Act of 1969 Reformed by Regulation*, 28 *TAX L. REV.* 65, at 82 (1972). This design for the 80-percent test gives it a different function from the 50-percent test of IRC § 1563

(a)(2)(B), since it is clearly undisputed even by the Government that the 50-percent test is one of control, based on its requirement of "identical interests." (*Petitioner's Brief* at p. 15). (Furthermore, this function differs radically from the function the Government would attach to the 80-percent test, i.e., assuring a "closely held" status. (*Petitioner's Brief* at p. 35).)

In fact, it is clear that the only purpose behind the then new, additional 50-percent test of § 1563(a)(2)(B) was to permit corporations that were 80 percent commonly owned, but in widely differing proportions, to fall outside the definition of a controlled group by ultimately focusing on only the "identical" ownership interest of each person in each corporation.[5] Yet the regulations actually utilize the 50-percent test, rather than the 80-percent test, to measure not only identical ownership, but common ownership in the first instance. A recent article effectively further discusses this point as follows:

> "As expressed by Treasury's General Explanation, the original 80 percent test ownership group was to be expanded from one individual to five or fewer to avoid the potential for easy avoidance of the original control test where the actual ownership group was larger than one individual, yet was still small enough that the corporations involved could be effectively manipulated as if they were one. The 50 percent test was added to insure that the application of the expanded definition was restricted to only those cases where the ownership group held their 80 percent in such a way as to permit them to in fact control the group of corporations as a single econo-

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5 It is clear that the 80-percent test can be met while the 50-percent test failed under such circumstances when the following example given by the Court of Claims is considered: the stock of one corporation is owned 80 percent by A and 20 percent by B. The stock of another corporation is owned 20 percent by A and 80 percent by B. "The 80-percent test is met regardless of which interpretation is correct. The 50-percent test would not be met . . . ." since there exists only a 40% identical interest." (Pet. App. 8a, fn3).

> mic enterprise. If Congress had intended to require only that the ownership group maintained control over the corporations in the controlled group, the 50 percent test would have been sufficient to accomplish that objective since, theoretically, control may be exercised by those individuals in possession of the majority of the stock. By retaining the 80 percent test, it is apparent that Congress intended to require more than just control. As it had done in the original enactment, Congress intended the individuals in the ownership group to possess a financial interest in each corporation in the controlled group." Student Comment, *Brother-Sister Controlled Groups: Tax Court Stands Firm in the Face of Reversal,* 13 CREIGHTON L. REV. 543 (1979) (citations omitted).

Accordingly, Congress in passing § 1563(a)(2) must have intended that the brother-sister controlled group rules come into effect only when *two* tests are met: that is, (1) when identical stockholders are found having *control* of each corporation (the 50-percent "identical interest" test), *and* (2) when stockholders are found having a sufficient *financial interest* in (the 80-percent "financial interest" test) *each* of the corporations in the alleged controlled group. These are clearly separate functions. Consequently any arguments by the Government that the 80- and 50-percent tests are duplicative or that the 50-percent test is "purposeless" and without a function under the Court of Claim's reasoning must fail.

Therefore, the best reflection of Congress's intent in passing IRC § 1563(a)(2) must be that for a person's stock ownership to be taken into account for purposes of the 80-percent test, that person must have a financial interest in each member of the brother-sister controlled group. An individual can have a financial interest in the operation of a corporation only if he owns stock therein. Consequently, to take into consideration for purposes of the 80-percent test the ownership of an individual who does not own stock in any corporation in the alleged controlled group would defeat the goals and intent of Con-

gress in requiring financial interests by each party in each corporation.

Indeed, the admittance of an individual without financial interests in all the corporations comprising the ownership group pursuant to Treas. Reg. § 1.1563-1(a)(3) acts to render the 80-percent test irrelevant:

> "The 50 per cent test is, as a majority opinion notes, a test of *control.* The use of identical interests for purposes of this test is to identify the degree of control necessary to allow the corporations 'to operate * * * as one economic entity.' The 80 per cent test, on the other hand, is one of *financial interest.* To me, it makes little sense to depart from the language and purpose of this statute by permitting the financial interest test to be satisfied by a different group of five or fewer persons for each one of the companies within the controlled group. *Such a construction renders meaningless the additional 80 per cent test. 'If control (more than 50 per cent ownership) is in a few persons, what is added by a requirement that an additional 30 per cent be owned by someone else?* The presence of the 80 per cent test only makes sense when viewed as a test of *substantial financial interest by the persons in control of the corporations.* In other words, the statute requires that five or fewer persons have common control of two or more corporations and that those same five or fewer persons have at least an 80 per cent financial interest in each corporation.'" *T. L. Hunt, Inc. v. Commissioner,* 562 F2d 532 at 536-537 (Webster, J., dissenting). (Emphasis added.).

Consequently, it can only follow that the 80-percent test is meaningless unless it is applied to only those who have ownership interests in each corporation. The Tax Court further amplified Judge Webster's analysis on this point:

> "By the same token, respondent's interpretation is contrary to the function of the 80-percent test and its

concomitant interrelationship with the 50-percent test. Manifest from the legislative history is the proposition that the 50-percent test is one of control, drawn to insure that the members of the controlled group could be organized and operated as one corporation. Hearings on the Subject of Tax Reform Before the House Comm. on Ways and Means, 91 Cong., 1st Sess. 5396 (1969). The 50-percent test being the control test, it is apparent that the 80-percent test is one of *financial interest*. Together, the tests assure that the sanctions imposed by section 1561 are applied only in those instances where the evil sought to be remedied rears its head, i.e., where those in control of two or more corporations are utilizing the multicorporate form to obtain an unwarranted financial benefit. To allow the 80-percent ownership test to be satisfied with stock of a person owning stock in only one corporation, i.e., a person not within the control group, would simply ignore the basic function of the 80-percent test." *Fairfax*, 65 T. C. at 805-806.

Accordingly, it is not the *Fairfax*, Fifth Circuit, and Court of Claims rationale that mangles congressional intent, as the Government would have this Court believe; rather, it is the excessive and overbroad regulating present in Treas. Reg. § 1.1563-1(a)(3). Consequently, this Court is respectfully urged not to allow the regulation in question to impose a limitation on the surtax exemptions for VFC and VPC in violation of what was actually intended in IRC §§ 1561 and 1563. As Judge Webster so aptly points out:

"There is nothing in the legislative history to suggest that Congress intended to penalize companies in which there were five or fewer shareholders. *It is not the smallness of the number of persons in each company that triggers § 1563; it is the sameness of that small number.* The 80 per cent financial interest requirement is meaningless unless it is the same

group of five or fewer persons that own 80 per cent of each company within the controlled group. It is this requirement of 'economic entity' which is entirely eviscerated by Reg. § 1.1563-1(a)(3)." *T. L. Hunt, Inc. v. Commissioner*, 562 F.2d 532 at 537 (Webster, J., dissenting). (Emphasis added.).

3. The Government attempts to draw further support for its arguments from legislative history where it was stated that "the stock ownership test of section 1563 (a)(2) would be the same test employed in Section 1551(b) (2) of the Code." H.R. REP. NO. 413, (Pt. 2), 91st Cong., 1st Sess. 76, 99 (1969). The Government then directs the Court's attention to Treas. Reg. § 1.1551-1 (g)(4), Example 4, which it asserts indicates that common ownership for purposes of the 80-percent test is not required. (*Petitioner's Brief* at p. 31-32). As the Court of Claims noted, however, the examples provided in Treas. Reg. § 1.1551-1 "are capable of more than one interpretation." (Pet. App. 26a).

The Government's argument in this regard is, in effect, two-fold: (1) Treas. Reg. § 1.1551-1 "supports the validity of the Section 1563 Regulations . . . ." (*Petitioner's Brief* at p. 33); and (2) Congress approved Treas. Reg. § 1.1551-1 through "statutory reenactment," or the doctrine of statutory incorporation of a prior administrative ruling.[6] The second prong of the Government's argument, i.e., statutory reenactment or incorporation, will be treated first.

It is crucial in this regard to note that Congress specifically limited its cross-reference in this particular segment of legislative history to the *statutory* language of IRC § 1551, and did not refer to the Treasury Regula-

6 The government also has asserted that Congress has approved Treas. Reg. § 1.1563-1(a)(3) because the Employer Retirement Income Security Act of 1974 (ERISA), Pub. L. No. 93-406, §§ 1013(c) (1) and 1015, 88 Stat. 921, 925, incorporated § 1563(a) by reference in sections 404(a)(1)(c) and 414(b) of the Internal Revenue Code at a time when Treas. Reg. § 1.1563-1(a)(3) had already been published. *Petitioner's Brief* at p.33, fn. 7. see p.31, *infra*

tions thereunder, which had only been in existence for 22 months at the time Section 1563 was enacted. (Pet. App. 25a). While Congress may certainly incorporate by reference regulatory interpretation of a statute, it is not at all certain that such occurred with regard to Treas. Reg. § 1.1551-1. Incorporation by reference is dependent upon the intent of Congress, which appears in this instance to dictate that the regulations under IRC § 1551 were not to be so incorporated, contrary to the position of the Government. The use of the word "employed" in the legislative history clearly acts to incorporate the statutory language of IRC § 1551(b)(2); it does not indicate, however, that Treas. Reg. § 1.1551-1 was also to be incorporated, and indeed is not sufficient or positive proof that Congress had any knowledge of that regulation when enacting IRC § 1563. As the Court of Claims noted, "While it is clear that Congress intended the same statutory test to be applied . . ., there is no indication . . . that Congress was aware of or approved any regulation interpreting the control requirements for brother-sister corporations." (Pet. App. 24a-25a). Absent such proof and in view of the brief amount of time the regulations under IRC § 1551 had then been in effect, it is argued that Treas. Reg. § 1.1551-1 should not be deemed to have been incorporated into IRC § 1563(a)(2) by the legislative history's reference to IRC § 1551(b)(2), as the Government has assumed throughout. *See generally, United States v. Calamaro*, 354 U.S. 351 (1957); 1 MERTENS, LAW OF FEDERAL INCOME TAXATION § 3.23 (rev. 1974), and cases cited therein; 2 AM. JUR.2d, *Administrative Law* § 252-253 (1972), and cases cited therein. *See also, infra* p.31.

Consequently, the entire morass of inconsistencies and inferences (as described hereafter and by the Court of Claims) of the "I.R.C. § 1551 regulation" analogy argument made by the Government, and specifically Treas. Reg. § 1.1551-1(g)(4), Example 4 (upon which the Government places heavy reliance), may not be relevant to the issue at hand, or at best may be inconclusive as to

Congress' intent in enacting IRC § 1563(a)(2). Nothing could be more inconclusive than a situation where the regulations under IRC § 1551 are not applicable at all.

But even assuming that the Regulations under IRC § 1551 do apply, it is clear that they do not establish the interpretation which the Government is asserting Congress approved (the "first prong" of the Government's argument in this regard). For instance, nowhere under Treas. Reg. § 1.1551-1 do the words "singly or in combination" appear. If Congress did intend to incorporate Treas. Reg. § 1.1551-1, it is clear that the "singly or in combination" concept was not part of that incorporation. Any broader interpretation by Treas. Reg. § 1.1563-1 (a)(3) is thus out of step with the Congressional understanding of IRC § 1551. The Court of Claims held, accordingly, that (Pet. App. 26a):

> "Any implied congressional approval must necessarily be limited to the literal wording of the regulations and cannot be extended to a possible inference or interpretation. *Montana Power Co. v. United States*, 232 F.2d 541, 549 (3rd Cir.), *cert. denied*, 352 U.S. 843 (1956). In drafting Treas. Reg. § 1.1551-1, the Treasury did not add the words 'singly or in combination' to the statutory language as it did to the same language in Treas. Reg. § 1.1563-1(a)(3). Furthermore, the Treasury did not provide an explicit example such as Treas. Reg. § 1.1563-1(a)(3)(ii), Example (1), to show that persons owning stock in only one corporation can be counted in the 80-percent test."

While the Government asserts that Example 4 to Treas. Reg. § 1.1551-1(g)(4) supports their position, they omit discussion of the fact that several other examples are contained within the Regulation which can be said to support VFC's position. Indeed, the Court of Claims felt that even Example 4 could indicate a proposition contrary to that advocated by the Government (Pet. App. 27a):

"Another example, Treas. Reg. § 1.1551-1(g)(4), Example (4), on which defendant relies, may indicate a contrary proposition. In this example, individual A owns 55 percent of the stock of corporation X. Another 25 percent of the stock of X is owned in the aggregate by individuals B, C, D, and E. Individual A transfers property to corporation Y in exchange for 60 percent of the stock of Y, and B, C, and D acquire all of the remaining stock of Y. The example concludes, without providing any rationale, that the transfer is within the scope of section 1551(a)(3). Defendant argues that the example demonstrates that owning stock in both corporations is not a requirement of the 80-percent test. *However, the examples under paragraph (g) of Treas. Reg. § 1.1551-1 are intended as illustrations of the nature of the transfer required under that paragraph rather than as illustrations of the meaning and application of the term 'control' discussed in paragraph (e).* It has been suggested that the example merely illustrates that a transfer can be made by one, rather than all, of the individuals in control of the transferor corporation or that the controlling stockholders of the transferee corporation must come from the group of five or fewer stockholders of the transferor but need not include all of the members of that group. Bonovitz, *Brother-Sister Controlled Groups under Section 1563: The 80 Percent Ownership Test,* 28 TAX LAWYER 511, 524-28 (1975). These suggested constructions of the example would not conflict with our interpretation of section 1563(a)(2) and are just as likely to be the proper construction of an ambiguous example as that of defendant's."

Thus, Example 4, as isolated by the Government, was clearly intended to illustrate only the "transfer" requirements of Section 1551, requirements that are irrelevant to the control aspects essential to IRC § 1563.[7] If

7 The error by the Government on this point is made further clear

Treas. Reg. § 1.1551-1 is applicable at all to IRC § 1563(a)(2), then only the *control* aspects of that regulation are relevant.

Only one subsection of Treas. Reg. § 1.1551-1 can be found that deals explicitly with "control." Subsection (e) of Treas. Reg. § 1.1551-1 is entitled "Meaning and Application of the Term 'Control.'" (See Appendix, *infra.*). That subsection contains a definition of "control" similar to that of Treas. Reg. § 1.1563-1(a)(3), but again with the vital difference of containing *neither* the phrase "singly or in combination," or an example such as Treas. Reg. § 1.1563-1(a)(3)(ii), Example 1.[8] Clearly, therefore, if Congress was looking to Treas. Reg. § 1.1551-1 when enacting IRC § 1563, it did not authorize a regulation such as Treas. Reg. § 1.1563-1(a)(3).

It is further submitted, however, that there are examples of Treas. Reg. § 1.1551-1 outside of the "control" portion of that Regulation (which the Government did not discuss) that arguably deal with the question of control, (which it is clear the Government's "Example 4"

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when the statutory language of IRC § 1551(b)(2) is examined. The very language of IRC § 1551 contains six elements, some of which are *control* requirements and others of which are *transfer* requirements. For purposes of IRC § 1563, we are obviously interested only in the *control* portions of § 1551. (The Regulations under IRC § 1551 are themselves similarly organized into eight subsections designed and formulated to indicate the scope of the interpretation contained therein). The control elements provide that five or fewer persons must control a corporation and the transferor or transferors must, after the transfer, control the transferee corporation. These "two" groups are the same under IRC § 1551, and this single group must satisfy the control requirements with respect to the two corporations in question under IRC § 1551. Thus, the IRC § 1563(a)(2) group should also evidence common ownership under the 80-percent test.

8 Indeed, the only example given under Treas. Reg. § 1.1551-1(e) illustrates a situation where each stockholder owns stock in *each* corporation. Treas. Reg. § 1.1551-1(e)(3). Congress, if it reviewed such an example, no doubt thus understood and intended common ownership to apply to the 80-percent test of IRC § 1563(a)(2).

does not) and can be said to support VFC's position (or at least undermine the Government's position):

> "Example (2). On June 20, 1963, individual A, who owns all of the stock of corporation X, transfers property (other than money) to corporation Y, a corporation not actively engaged in business at the time of the acquisition of such property, in exchange for 60 percent of the voting stock of Y. During a later taxable year of Y, A acquires an additional 20 percent of such voting stock. After such acquisition A owns at least 80 percent of the voting stock of corporations X and Y. Accordingly, section 1551(a)(3) is applicable for the taxable year in which the later acquisition of stock occurred and for each taxable year thereafter in which the requisite control continues." Treas. Reg. § 1.1551-1(f)(2), Example 2.

Under this Example (2), then, the ownership test is not met until all persons counted own stock in both corporations. See also, Treas. Reg. § 1.1551-1(e)(3) and (f)(2), Example (3). Thus, based on these examples in Treas. Reg. § 1.1551-1, VFC's arguments are further strengthened.

Even if, however, one does not agree totally with this analysis of the examples of Treas. Reg. § 1.1551-1, it seems that the worst that can occur from VFC's standpoint is that such an analysis will be deemed inconclusive due to the apparent inconsistencies, as the Court of Claims ultimately found. The Tax Court's position on this particular point is as follows:

> "Both parties make reference to section 1.1551-1, Income Tax Regs., as being relevant to the disposition of the present case. Briefly, this regulation interprets the 80-percent test of section 1551(b)(2) to require that the five or fewer persons who own 80 percent of the transferee also be *one or more* of the five or fewer persons who own 80 percent of the transferor; however, there is no requirement that each of the persons who own 80 percent of the

transferor corporation must also own stock in the transferee corporation. While we express no opinion regarding this interpretation of section 1551(b)(2), we note that it is not a viable interpretation of section 1563(a)(2). If NOVA were deemed to be the transferor corporation, under such an interpretation NOVA and FAP would constitute a brother-sister controlled group. If FAP were deemed the transferor corporation they would not. Since respondent has pointed to no method of determining which corporation is to be regarded as the transferor, and we find none ourselves, we cannot engraft such an interpretation on section 1563(a)(2)." *Fairfax*, 65 T.C. at 806-807.

It is suggested that this same process of "engraftment" rejected by the Tax Court should also be rejected by this Court. For example, if VFC is deemed to be the transferor corporation, then VPC and VFC would constitute a brother-sister controlled group under IRC § 1551. However, if VPC is deemed the transferor, then (just as the Tax Court's example above illustrated) they are *not* a brother-sister controlled group. Section 1551 is thus clearly designed for a different factual and legal situation than is found under IRC § 1563, and when the attempt is made to apply its principles to the current factual problem, inconsistent results occur depending upon which corporation is chosen as the transferor in making the analogy. Such inconsistent results make the Government's arguments comparing IRC § 1551 with § 1563 of little use.

To summarize and cut across the fog in this area, it seems best to cite the argument well made by Bonovitz in an often-cited article:

"The regulations under section 1551, albeit ambiguous as to the question of common ownership, should be construed to require common ownership. The legislative history of section 1551(b)(2) unequivocally requires common ownership. Had the

draftsman of the regulations intended to deviate from the legislative mandate, he would surely have done so with greater clarity. Regulation Section 1.1551-1(e), dealing with the definition of control in section 1551(b)(2), implies a requirement of common ownership in each corporation by each shareholder; the only example in this regulation is one in which there is common stock ownership by the shareholders. The examples in section 1.1551-1(f) of the regulations, involving the taxable year of the allowance or disallowance in section 1551(a), are also consistent with this construction. The only inconsistency in the regulations is the example contained in section 1.1551(g), which deals with 'transfers' under section 1551(a). This one example, if construed to require less than common ownership, must, when balanced against the unambiguous legislative history of section 1551 and the more pertinent discussion in the regulations which points toward a common ownership requirement, *give way to the conclusion that the regulations under section 1551(b)(2) require that each of the shareholders owns stock in each corporation.*" Bonovitz, *Brother-Sister Controlled Groups Under Section 1563: The 80 Percent Ownership Test*, 28 *TAX LAW* 511 (1975).

4. In a manner similar to its arguments concerning the significance of Treas. Reg. § 1.1551-1, see p.24, *infra*, the Government has implied that the passage of the Employee Retirement Income Security Act of 1974, by incorporating by reference the controlled group definitions of IRC § 1563(a) in IRC § 414(b), shows that Congress implicitly approved of Treas. Reg. § 1.1563-1(a)(3). (*Petitioner's Brief* p. 33-34, fn. 7). This argument, however, has also been rejected by the Tax Court and the Court of Claims. In *Allen Oil Company, Inc.*, the Tax Court noted:

"ERISA was made law on September 2, 1974. . . .

> The regulation which respondent claims Congress thereby tacitly approved first appeared on April 25, 1972. . . . We think it questionable that, when Congress incorporated by reference its definition of controlled group as contained in section 1563(a), it also meant to incorporate and approve respondent's then recently promulgated regulatory interpretation. *The deference sometimes shown by courts for long standing regulations which have survived many congressional enactments can hardly be said to apply to regulations not even 1.5 years old at the relevant time." Allen Oil Company, Inc.*, T.C.M. 1979-88 (CCH) at 357, fn. 2 (citations omitted).

The Court of Claims similarly rejected the impact of ERISA's passage on the question herein. (Pet. App. 24a-25a).

The Tax Court's and Court of Claims' positions cited above are consistent with the generally accepted rules of statutory interpretation. The doctrine of statutory incorporation of a prior administrative ruling (even in cases of reenactment of a statute without substantial change) is generally found not to apply where the regulation has been in effect for only a short time before such reenactment, especially where there is no positive proof that Congress had some knowledge of the regulation. In *United States v. Calamaro*, 354 U.S. 351 (1957), statutory incorporation of a regulation by reenactment was not allowed where the regulation had been in effect for only *three* years and there was nothing to indicate that it was ever called to the attention of Congress. Since Treas. Reg. § 1.1563-1(a)(3) was in effect (as compared to published) for not even 1.5 years at the time ERISA was passed, and since no evidence is shown of Congress' knowledge of the regulation, statutory incorporation by reenactment is not properly invoked.[9] In any event, even reenactment of a statute

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9 See also, Commissioner v. Glenshaw Glass Co., 348 U.S. 426 (1955); *Augustus v. Commissioner*, 118 F.2d 38 (6th Cir. 1941);

cannot shield a regulation where the regulation is found to improperly interpret the statute, as does Treas. Reg. § 1.1563-1(a)(3). *Janney v. Commissioner*, 108 F.2d 564 (3rd Cir. 1939), *aff'd sub. nom., Helvering v. Janney*, 311 U.S. 189 (1940).

Consequently, the Government's arguments for Treas. Reg. § 1.1563-1(a)(3) cannot be upheld on this basis. As *Mertens* notes:

> "In complex income tax law it is absurd to indulge in the fiction that the full import of Treasury Regulations and administrative practice is known to the members of Congress. Statutes have been frequently re-enacted without any consideration given to many of the specific sections of the act, the re-enactment being concerned primarily with a revision of a limited number of sections to close loopholes and the addition of a few new sections. As the Supreme Court stated in the case of *Helvering v. Halcock* [309 U.S. 106 (1940)]: '. . . we walk on quicksand when we try to find in the absence of corrective legislation a controlling legal principle.'" 1 *MERTENS, LAW OF FEDERAL INCOME TAXATION* § 3.24 (rev. 1974) at p. 57.

5. Finally, the unjustified and unreasonable expansion by the Regulations of the intended impact of IRC § 1563(a)(2) was seen clearly by the Tax Court in rebutting the Government's argument to the effect that Treas. Reg. § 1.1563-1(a)(3) acts to "fill a loophole" left by Congress in the statute:

"Respondent, however, urges that we sanction

Commissioner v. F.H.E. Oil Co., 102 F.2d 596 (5th Cir. 1939), *aff'd* 308 U.S. 104 (1939); *Eastman Kodak Co. v. United States*, 48 F. Supp. 357 (Ct.CL. 1943); *Hugoton Production Co. v. United States*, 349 F.2d 418 (Ct.Cl. 1965); *Casey v. Sterling Cider Co.*, 294 F. 426 (1st Cir. 1923); *Commissioner v. Sun Pipe Line Co.*, 126 F.2d 888 (3rd Cir. 1942); 1 *MERTENS, LAW OF FEDERAL INCOME TAXATION* § 3.23 (rev. 1974), and cases cited therein; 2 AM. JUR.2d, *Administrative Law* § 252-253 (1972), and cases cited therein.

his statutory interpretation as evidenced by the aforenoted regulation to preclude an easy path on which to bypass controlled group status in the brother-sister context. We do not find it a realistic belief that an individual would dispose of his entire interest in a corporation to enable that corporation and its remaining shareholders to reap the financial benefits of a full surtax exemption. To the contrary, respondent's interpretation permits him to snare with the definitional web woven by the words 'singly or in combination' corporations that Congress never intended to bring within the ambit of the multicorporate provisions." *Fairfax*, 65 T.C. at 805.

In a footnote to the above quote, the Tax Court supplied the following example of how the Government's position adds to the statute what was not intended because of its tendency to unfairly "surprise" minority shareholders with the loss of the surtax exemption because of actions taken possibly unbeknown to them by a majority shareholder over whom they have no control:

"A prime example is a variant of the factual situation involved herein. Individual A owns 55 percent of corporation X and individual B owns 45 percent thereof. If A were independently to enter into a second business in corporate form the corporations would be component members of a controlled group. We cannot believe that Congress intended to surprise B with such a result. We recognize that had A owned 80 percent of corporation X and B 20 percent thereof, the corporations would constitute a controlled group. However in the latter instance, B's unfortunate surprise would be necessitated by both the mechanical application of the stock ownership tests and the respective functions of the 80 percent and 50 percent tests discussed *infra*." *Fairfax*, 65 T.C. at 805, fn. 5.

It is this inequitable surprise that is bestowed

upon minority shareholders under Treas. Reg. § 1.1563-1 (a)(3) that vitiates and ultimately destroys what the Government has described as "the most telling point against the statutory interpretation . . . ." by the Court of Claims, Tax Court, and Fifth Circuit, i.e., that VFC and VPC "would have constituted a brother-sister controlled group if Richard Crain owned but a single share of Vogel Popcorn." (*Petitioner's Brief* at p. 10, 24-26). Congress *must* have intended the statute turn on ownership in both corporations (contrary to the Government's assertions), even if such ownership consists of only one share, since an increase in taxes should equitably only be suffered in this case because of an affirmative action taken by the taxpayer himself, rather than by actions of another stockholder completely outside his control. As the Court of Claims noted (Pet. App. 32a-33a):

> "Defendant contends that had Congress intended to require common ownership as part of the 80-percent test, it would have provided for some minimum and meaningful level thereof and would not have left it to turn upon the happenstance of a symbolic but factually meaningless ownership of a single share. Defendant's argument may seem valid in the abstract but it has no merit when the predictable actions of real taxpayers are considered. It might well be appropriate not to consider the ownership of a token amount of stock if taxes could be *avoided* by such ownership. Here the ownership of a token amount of stock would *increase* taxes, and Richard Crain would be most ill advised to acquire one share of stock in Vogel Popcorn and so cause the 80-percent test to be satisfied. Presumably, Mr. Crain is aware of the tax laws and would only acquire stock in Vogel Popcorn if he wished to make an investment of sufficient magnitude to compensate for the loss of a surtax exemption." (Emphasis in text).

Richard Crain in this instance must believe that the "surprise" of losing the surtax exemption because a fellow shareholder happens to own another corporation completely separate from Mr. Crain is a result not intended by Congress. When viewed from this standpoint, it becomes even more clear that the Government's proposed definition of a brother-sister control group is a totally unwarranted extension of the statutory language of IRC § 1563(a)(2), and is therefore an unrealistic and unreasonable interpretation of the statute. As such, Treas. Reg. § 1.1563-1(a)(3) must be found invalid.

Furthermore, the common ownership requirement in the 80-percent test is hardly one of "no economic significance" turning upon "minute distinctions [that] make no economic difference." (*Petitioner's Brief* at p. 25). Stock ownership, even one-share stock ownership, carries with it significant rights, opportunities, and disabilities:

> "The shareholder may vote to elect and remove directors, adopt, amend and repeal bylaws, adopt resolutions, affect extraordinary corporate matters, and see corporate books and records. See Henn, Law of Corporation §§ 188, 189, 192, 193, 194, 195 & 199 (2d ed. 1970). He also has standing to bring suit against an officer or director of the corporation who breaches his fiduciary duties to the entity, or under the Securities Act of 1934. *See id.* at § 200; *Rekant v. Desser*, 425 F.2d 872, 876 (5th Cir. 1970)." *Delta Metalforming*, 632 F.2d at 450.

Consequently, Congress by requiring the principle of common ownership in the 80-percent test has not been criticized fairly by the Government through their objections that such a requirement may be hardly meaningful, trifling, or turning upon an economically meaningless fact in some instances.

Nor does the application of the principle of common ownership subvert Congress's intent in passing the

controlled group definitions of IRC § 1563(a), as the Government argues. (See *Petitioner's Brief* at p. 25; fn 4, p. 25-26). The original purpose of the surtax exemption, enacted in 1950, was to reduce the tax burden on small businesses. *See* Revenue Act of 1950, ch. 994, § 15(b), 64 Stat. 915 (repealed 1978) (formerly codified at IRC § 11(c).) *See also* H.R. REP. NO. 2319, 81st Cong., 2d Sess. 26-27 (1950); *Hearings on the President's 1963 Tax Message Before the House Comm. on Ways and Means,* 88th Cong., 1st Sess., pt. 1 at 5 (1963). Small businesses were to be stimulated (not penalized as was VFC under Treas. Reg. § 1.1563-1(a)(3)) by the lowering, in effect, of their effective tax rate on their surtax exemption income. Congress enacted and revised IRC § 1563(a)(2), on the other hand, in response to the specific problem of large companies subdividing into many small corporations so as to obtain multiple exemptions and the resultant lower effective tax rate. *See* Revenue Act of 1964, Pub. L. No. 88-272, § 235(a), 78 Stat. 116. The problem Congress faced, and solved, in enacting § 1563(a)(2) was to design a statutory scheme, therefore, that identified the "small" corporations that were actually components of much larger business units while still giving the benefit of the surtax exemption to those it was originally intended to benefit, i.e., the "bona fide" small business. This design can only be carried out if the principle of common ownership is applicable to the 80-percent test, since the only means of discovering the link between those "small" corporations which are part of that "large economic entity" is by the financial interest the large entity has in the small.

In order to measure common ownership in this manner, then, the 80-percent test could only have been meant by Congress to take into account only the stockholdings of persons (or entities) who own an interest in each corporation in the alleged controlled group. Indeed, only with this type of test is there symmetry between the brother-sister controlled group tests and

the test determining parent-subsidiary controlled groups under IRC § 1563(a)(1) (Pet. App. 29a-30a):

> "Furthermore, section 1563(a)(1) provides persuasive evidence that Congress would require a significantly greater overlap of stockholdings than 50 percent before it would treat two or more corporations as one entity. Section 1563(a)(1) defines a 'parent-subsidiary controlled group' as existing where a parent corporation owns stock representing 80 percent of the value or voting power of one or more subsidiary corporations either directly or indirectly through a subsidiary. It seems highly unlikely that Congress would require a lesser identity of ownership between brother-sister corporations owned by up to five persons than between a more centralized and more easily controlled parent-subsidiary group."

It seems that what the Government is really objecting to is the power of Congress to set percentage requirements in the area of tax law. However, it is obvious that the Government does not have the power or right to make such an objection, as it is the Congress (and not the Treasury) that is empowered to write the numerical requirements necessarily a part of tax law. The Fifth Circuit aptly stated this fact of tax law, which the Government desires to ignore through Treas. Reg. § 1.1563-1(a)(3):

> "Particularly in the area of federal taxation, we should not ignore percentage requirements obviously and specifically fixed by Congress. While the result may seem 'arbitrary' — ownership of a single share may be critical — 79% will not suffice while 80% will — revenue laws necessarily encompass maximums, minimums, cutoffs and the like. In that sense all specific standards expressed in numbers or percentages are arbitrary. One side of the line is IN, the other side OUT." *Delta Metalforming*, 632 F.2d at 450.

In this matter, it is clear that Treas. Reg. § 1.1563-1(a)(3) is "OUT" as an attempt by Treasury to rewrite the application of the percentage requirements set by Congress.

B. The application of the principle of common ownership to the 80-percent test is compelled by the statutory language of Section 1563(a)(2).

In support of the statutory construction by which it counts Mr. Crain's stock, the Government has advanced the theory that the "natural reading" of the statute results in the conclusion that "it is only with respect to the 50% test that the statute imposes the requirement that some of the five or fewer persons own stock in each corporation." *(Petitioner's Brief* at p. 20). The Government asserts, therefore, that the fundamental error of the Court of Claims, Tax Court, and Fifth Circuit was to ignore the fact that the phrase "each such person" is "found only in sub-paragraph (B) with respect to the 50% test." (*Petitioner's Brief* at p. 9).

The major problem with the "natural reading" theory of the Government is that it ignores well-established and commonly used guidelines of English usage and grammer. *See, e.g., Delta Metalforming,* 632 F.2d at 446 (dictionary definitions of the statutory terminology underscore and compel "a reading requiring that for the 80% test each shareholder must own stock in each of the corporations."). A proper grammatical analysis of the statute results in a conclusion that the principle of common ownership (but not, as explained more fully hereafter, *identical* ownership) applies to the 80-percent test just as it applies to the 50-percent test. To rebut the Government's arguments concerning statutory construction, VFC can do no better than to reiterate the Tax Court's majority opinion in *Fairfax,* upon which the Court of Claims placed great weight. The Tax Court dismissed the Government's arguments as follows:

"The key words of the statute relevant to an analysis of the issue are:

'if 5 or fewer persons . . . own . . .

(A) at least 80 percent . . . of each corporation, and

(B) more than 50 percent . . . of each corporation, taking into account the stock ownership of *each such person* only to the extent such stock ownership is identical with respect to each such corporation'.

"Since the 'five or fewer persons' is the conjunctive subject of both the 80-percent test and the 50-percent test, it cannot be gainsaid that both tests must be satisfied by the same ownership group. However, to gain entrance into the ownership group for purposes of the 50-percent test one must possess stock in each corporation involved since an absence of such stock ownership produces an identical stock ownership of zero or, put another way, no stock ownership at all. If ownership of stock in each corporation involved is a precondition to membership in the ownership group for purposes of the 50-percent test, and the ownership groups for the 50-percent test and 80-percent test are one and the same, *it follows in our mind that one must own stock in each corporation before his stock can be taken into account for purposes of the 80-percent test.*

"Furthermore, the language of the 50-percent test comports with this analysis. The words 'each such person' appearing therein refer to the 'five or fewer persons' constituting the ownership group for purposes of both the 80-percent and the 50-percent tests. The import of such usage is that each person — and not just some of the persons — counted for purposes of the 80-percent test must be also counted for purposes of the 50-percent test. To interpret the

statutory language as respondent has done in his regulation is plainly inconsistent with the thrust of the statutory language. Hence, we hold that for a person's stock ownership to be taken into account for purposes of the 80-percent test that person must own stock in each member of the brother-sister controlled group. Since respondent's regulations advance a contrary interpretation, we hold them, to that extent, invalid." *Fairfax*, 65 T.C. 798, 803 (1976). (Emphasis added).

Accordingly, the application of the principle of common ownership to the 80-percent test is compelled by the rules of English usage and grammar. The use of a common tool of statutory construction, the "last antecedent doctrine," confirms this conclusion, as it obtains the same result. The Court of Claims illustrated this point as follows (Pet. App. 11a-12):

"Defendant further relies upon the 'last antecedent' doctrine to dispute that the phrase 'each such person' in the 50-percent test refers to the '5 or fewer persons' who are the subject of both tests. This doctrine requires that qualifying words, phrases, and clauses in a statute are to be applied to the words or phrase immediately preceding and are not to be construed as extending to and including others more remote. *Azure v. Morton*, 514 F.2d 897, 900 (9th Cir. 1975); *Quindlen v. Prudential Ins. Co. of America*, 482 F.2d 876, 878 (5th Cir. 1973). Defendant misunderstands the function of this doctrine, which, for example, would establish (in the absence of clarifying indentation) that the qualifying clause 'taking into account the stock ownership of each such person only to the extent such stock ownership is identical with respect to each such corporation only applies to the immediately preceding 50-percent test and not to the more remote 80-percent test. The phrase '5 or fewer persons' is the most immediately preceding refer-

> ence to 'persons' prior to the phrase 'each such person.' As such, both common English usage and the 'last antecedent' doctrine support the Tax Court's interpretation."

See also, 2A Sutherland, *Statutes and Statutory Construction* § 47.33 (4th ed. 1973); 82 C.J.S. *Statutes* § 334 (1981).

Thus, it can be seen that the mere location of the term "each such person," which is characterized by the Government as "The most striking characteristic of the statutory language and structure . . . ." in favor of its analysis (*Petitioner's Brief* at p. 20), does not afford the Government the comfort it has drawn from that factor. Rather, under the last antecedent doctrine the correct reading of the statute plainly requires that the 80-percent stock ownership be drawn from "each such person" of the group of "5 or fewer persons." Since, for purposes of the 50-percent test, that group of "5 or fewer persons" must own stock in each corporation to be counted, it is only logical that the principle of common ownership also then apply to the 80-percent test. *Fairfax,* 65 T.C. at 803; *Delta Metalforming,* 632 F.2d at 446; *T.L. Hunt, Inc. v. Commissioner,* 562 F.2d 532, 536 (8th Cir. 1977) (Webster, J., dissenting).

As the Government concedes, the Tax Court, Fifth Circuit, and Court of Claims have not suggested by this analysis, and VFC is not suggesting, that the "identical interest" portion of the 50-percent test is somehow drawn into the 80-percent test. The two tests remain completely separate components of the statute, one testing *identical* overlapping interests, and the other testing overlapping *financial* interests. Therefore, the 80-percent test does not "necessarily swallow up and displace the 50 percent test" under the Court of Claims decision, as implied by the Government. (*Petitioner's Brief* at p. 23).

The Government further objects that "the statutory interpretation by the Court of Claims contains no

limiting principle that makes any particular portion of subparagraph (B) any more or less appropriate for importation into subparagraph (A)." (*Petitioner's Brief* at p. 23). However, it is argued that the analysis by the Court of Claims *is* self-limiting by very reason of the last antecedent doctrine and other grammatical rules earlier discussed. The analysis by the Court of Claims is limited to the use of "intrinsic aids" commonly found in statutory interpretation to determine the qualifications of the group to whom the 80-percent test should apply. This process cannot and should not be extended further. Once it is established via these aids that the 80-percent test requires common ownership, the two tests then work separately and independently to fulfill their purposes, as Congress intended (and as discussed further herein).

When the language of IRC § 1563(a)(2) is thus correctly analyzed under well-established and commonly used guidelines of English usage and grammar, the statutory construction by the Court of Claims, Tax Court, and Fifth Circuit is clearly correct in requiring the application of common ownership to the 80-percent test. It can only be assumed that Congress intended to follow the rules of good grammar and English usage. Therefore, the result obtained from the application of such rules, i.e., the requirement of common ownership, must be the result intended by Congress, as the previous discussion of the legislative history and purpose of IRC § 1563(a)(2) has shown.

C. The deference usually given a Treasury Regulation is not appropriate in this case. The Commissioner does not have the authority to add to Section 1563(a)(2) by regulation what he thinks Congress has overlooked.

VFC well understands that in most instances, Treasury Regulations must be sustained unless shown to be unreasonable and plainly inconsistent with the revenue statutes. *Commissioner v. South Texas Lumber*

Co., 333 U.S. 496 (1948). This normal policy of "deference," however, is not appropriate in this case, as Treas. Reg. § 1.1563-1(a)(3) has been shown herein and by the Tax Court, Fifth Circuit, and Court of Claims to be unreasonable, inconsistent with the intent of Congress and purpose of the statute, and outside the authority of the Commissioner. *United States v. Cartwright*, 411 U.S. 546 (1973); *United States v. Calamaro*, 354 U.S. 351 (1957).

As *Mertens* notes, "The Treasury may not make an arbitrary or unreasonable Regulation, nor can it restrict or enlarge the scope of a statute, supply a supposed omission, create an exemption, limit any rights thereunder, or nullify a prior judicial construction of the statute." 1 *MERTENS, THE LAW OF FEDERAL INCOME TAXATION* § 3.21 (rev. ed. 1974). Treas. Reg. § 1.1563-1(a)(3) has been shown: (1) to be unreasonable in view of congressional intent and statutory purpose; (2) to enlarge the scope of IRC § 1563 by the "definitional web" of the words "singly or in combination"; (3) to be an attempt to supply a supposed omission to IRC 1563; and (4) to limit the rights of VFC and many other taxpayers to utilize the surtax exemption specifically given to them as small businesses by Congress. In view of this situation, the Government should not be allowed to hide behind the respect usually granted by this Court to the Commissioner's regulations, as Treas. Reg. § 1.1563-1(a)(3) has not earned that privilege.[10]

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10 Treas. Reg. § 1.1563-1(a)(3) has received almost universal criticism by commentators, starting from the date of the initial promulgation of the regulation. As noted by the Fifth Circuit, "the overwhelming opposition has special significance." *Delta Metalforming*, 632 F.2d at 449. See Libin and Abramowitz, *"Multiple Corporations: A Surprising Interpretation of Sec. 1563(a)(2) in* Temporary Regulations," 3 *TAX ADVISOR* 326 (1971); Thomas, *"Brother-Sister Multiple Corporation — The Tax Reform Act of 1969 Reformed by Regulation,"* 28 *TAX L. REV.* 65 (1972); Kringel, *"Multiple Corporation Proposed Regulations Raise More Questions Than They Answer,"* 36 *J. TAX.* 358 (1972); Pearlman, *"Recasting the Multiple Corporate Group after the Multiple*

As this Court has noted, the principle of deference to the administration efforts of the Commissioner is only designed so as "to set the framework for judicial analysis: it does not displace it." *United States v. Cartwright*, 411 U.S. 546 at 550 (1973). It does not follow that simply "because [the Commissioner] has a choice of alternatives, his choice should be sustained where the alternative chosen is unrealistic. In such a situation the regulations embodying that choice should be held to be unreasonable." *Id.* at 557. As stated by this Court in *Manhattan General Equipment Co. v. Commissioner*, 297 U.S. 129, 134 (1936):

> "The power of an administrative officer or board to administer a federal statute and to prescribe rules and regulations to that end is not the power to make law, for no such power can be delegated by Congress, but the power to adopt regulations to carry into effect the will of Congress as expressed by the statute. A regulation which does not do this, but operates to create a rule out of harmony with the statute, is a mere nullity. *Lynch v. Tilden*

Surtax Exemption Ends," 41 *J. TAX.* 194, 199 (1974); Bonovitz, *"Brother-Sister Controlled Groups Under Section 1563: The 80 Percent Ownership Test,"* 28 *TAX LAW* 511 (1975); Student Note, 1976 *BRIGHAM YOUNG LAW REV.* 100; Weisman, *"Brother-Sister Controlled Corporations: On and Off the Road to the Supreme Court With an Edsel,* 56 *TAXES* 475 (Aug. 1978); Student Comment, *"Brother-Sister Controlled Groups: Tax Court Stands Firm in the Face of Reversal,"* 13 *CREIGHTON L. REV.* 543 (1979); Student Comment, *"The Brother-Sister Controlled Group Under IRC* § 1563(a)(2)," 67 *VA. L. REV.* 751 (1981) Hoffman, *"The 80 Percent Ownership Test For Brother-Sister Controlled Groups: The Controversy Continues,"* 58 *TAXES* 329 (1980); Student Note, *"Brother-Sister Controlled Groups: The Basic Eighty Percent Stock Ownership Test as Control,"* 58 *TEXAS L. REV.* 1161 (1980); cf. White, *"The Tax Reform Act of 1969: Demise of Multiple Surtax Exceptions — When Too much of a Good Thing Proved its Undoing,"* 16 *WAYNE L. REV.* 1353 (1974).

Consequently, a substantial body of authorities exist to support a finding that Treas. Reg. § 1.1563-1(a)(3) is invalid.

Produce Co., 265 U.S. 315, 320-322 (1924); *Miller v. United States*, 294 U.S. 435, 439, 440 (1935) and cases cited."

The situation in this case requires a similar holding:

"It is questionable, however, whether such discretion should be given to the Treasury's interpretation of the statute in this instance for several reasons. First, the statute at issue is definitional and should not be applied beyond a narrow application without congressional approval. That is, the underlying effect of Section 1563 was to replace a subjective test with a mechanical test. The application of the Treasury's interpretation to the statute substantially broadens its impact. Because the statute is not only interpretative but also definitional it should be strictly construed. Second, as previously discussed, there are fundamental inconsistencies between the Treasury's interpretation of the language of the statute and Congress's intent. Third, the tax policy and functions underlying the purpose of the statute constitute 'weighty reasons' sufficient for the Court in this case not to defer so readily to the administrative interpretation of the Treasury." Weisman, *Brother-Sister Controlled Corporations: On and Off the Road to the Supreme Court With an Edsel*, 56 *TAXES* 475 at 482 (1978).

Furthermore, Treas. Reg. § 1.1563-1(a)(3) is clearly an example of an "interpretative" regulation drafted under the auspices of IRC § 7805, rather than a "legislative" regulation written in response to a specific delegation of authority by Congress. As such, the Regulation should not be considered as having the force and effect of law; rather, this Court is free to analyze, construe, and apply the statutory provisions of IRC § 1563 independent of such Regulation. *United States v. Cartwright*, 411 U.S. 546 (1973); 2 AM. JUR.2d, *Administrative Law* § 251 (1962). Where, as shown

earlier herein, the Regulation is found to be an erroneous administrative interpretation of a nonambiguous statute, and where, as here, the Regulation unilaterally and without authority expands the scope of the statute beyond that intended by Congress, thereby limiting the right of taxpayers to utilize the surtax exemption privilege granted by Congress, the Regulation should be found inconsistent with the law and inappropriate to accomplish the purposes of Congress. *See*, 1 *MERTENS LAW OF FEDERAL INCOME TAXATION* § 3.21 (rev. 1974).

As *Mertens* notes, "In determining the effect of Treasury Regulations it is important to keep in mind that the Treasury's interest is in revenue and naturally its Regulations are favorable to its maintenance rather than unbiased." *Id.* § 3.21 at 44-45. This bias of the Treasury in conflict with statutory provisions is clearly evident in Treas. Reg. § 1.1563-1(a)(3). By adding the words "singly or in combination," the Commissioner has deliberately and liberally expanded the intended impact of IRC § 1563. The Commissioner, however, has no more power to add to the Code what he thinks Congress overlooked, even to protect the revenue, than he has to supply what Congress has deliberately omitted. *United States v. Calamaro*, 354 U.S. 351, 359 (1957) ("we cannot but regard this Treasury Regulation as no more than an attempted addition to the statute of something which is not there."); *Arkansas-Oklahoma Gas Co. v. Commissioner*, 201 F.2d 98 (8th Cir. 1953). The Government may believe and argue that statutory verbal difficulties should be resolved in the interest of improving the health of the fisc, and thus assert that Treas. Reg. § 1.1563-1(a)(3) should be upheld. However, such an assertion is not a valid argument for promulgating overly broad regulations. *United States v. Calamaro*, 354 U.S. 351, 357 (1957) ("Neither we nor the Commissioner may rewrite the statute simply because we may feel that the scheme it creates could be improved upon."); *Estate of Willett*

v. Commissioner, 365 F.2d 760, 769 (5th Cir. 1966). This Court has held that simply because the Commissioner feels he can improve the phraseology of a statute or can improve the revenue collecting position, this is no justification to ignore statutory language or the intent of Congress. *United States v. Calamaro*, 354 U.S. 351, 359 (1957); *Morrill v. Jones*, 106 U.S. 466 (1883).

CONCLUSION

From the foregoing, it is clear that the language and intent of IRC § 1563(a) compels the conclusion that Treas. Reg. § 1.1563-1(a)(3) is invalid as a matter of law, and that IRC § 1563(a)(2) requires the principle of common ownership be applied to the 80-percent test. Analysis of the legislative history and the underlying purpose for the enactment of IRC § 1563(a) does not support the Government's position. By the addition of the phrase "singly or in combination" to the statutory language otherwise traced by Treas. Reg. § 1.1563-1(a)(3), Treasury has expanded the scope of IRC § 1563(a)(2) to ensnare corporations Congress never intended to trap. As such, the regulation is an unreasonable and overreaching interpretation of IRC § 1563(a)(2) and should not be upheld.

Consequently, this Court is respectfully requested to follow the clearly defined trail already blazed and marked by the Court of Claims, Fifth Circuit, and Tax Court, hold that VFC is not a member of a "brother-sister controlled group" within the meaning and intent

of IRC § 1563(a)(2), and allow VFC's claims for refunds by affirming the judgment of the Court of Claims.

Respectfully submitted,

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APPENDIX

STATUTES INVOLVED:

Internal Revenue Code of 1954 (26 U.S.C.):

I.R.C. § 11(d) [as amended by Revenue Act of 1964, Pub. L. No. 88-272, Section 121, 78 Stat. 25; and Tax Reform Act of 1969, Pub. L. No. 91-172, Section 401(b)(2)(B), 83 Stat. 602]:

> (d) *Surtax Exemption.* — For purposes of this subtitle, the surtax exemption for any taxable year is $25,000, except that, with respect to a corporation to which section 1561 or 1564 (relating to surtax exemptions in case of certain controlled corporations) applies for the taxable year, the surtax exemption for the taxable year is the amount determined under such section."

(Note: effective for taxable years ending in 1975, IRC § 11(d) was amended to provide a surtax exemption of $50,000.00. *See* Tax Reduction Act of 1975, Pub. L. No. 94-12, Section 303(b), 89 Stat. 26.).

* * * * *

IRC § 1561(a) [as added by Revenue Act of 1964, Pub. L. No. 88-272, Section 235(a), 78 Stat. 116; applicable for taxable years ending before January 1, 1975]:

> SURTAX EXEMPTIONS IN CASE OF CERTAIN CONTROLLED CORPORATIONS.
>
> (a) *General Rule.* — If a corporation is a component member of a controlled group of corporations on December 31, then for purposes of this subtitle the surtax exemption of such corporation for the taxable year which includes such December 31 shall be an amount equal to —
>
> (1) $25,000 divided by the number of corporations which are component members of such group on such December 31, or

(2) if all such component members consent (at such time and in such manner as the Secretary or his delegate shall by regulations prescribe) to an apportionment plan, such portion of $25,000 as is apportioned to such member in accordance with such plan.

The sum of the amounts apportioned under paragraph (2) among the component members of any controlled group shall not exceed $25,000.

* * * * *

IRC § 1561(a) [as added by Revenue Act of 1964, Pub. L. No. 88-272, Section 235(a), 78 Stat. 116, and amended by Tax Reform Act of 1969, Pub. L. No. 91-172, Section 401(a)(1), 83 Stat. 599, applicable for taxable years ending in 1975]:

LIMITATIONS ON CERTAIN MULTIPLE TAX BENEFITS IN THE CASE OF CERTAIN CONTROLLED CORPORATIONS.

(a) *General Rule.* — The component members of a controlled group of corporations on a December 31 shall, for their taxable years which include such December 31, be limited for purposes of this subtitle to—

(1) one $50,000 surtax exemption under section 11(d),

(2) one $100,000 amount for purposes of computing the accumulated earnings credit under section 535(c)(2) and (3), and

(3) one $25,000 amount for purposes of computing the limitation on the small business deduction of life insurance companies under sections 804(a)(4) and 809(d)(10).

The amount specified in paragraph (1) shall be

divided equally among the component members of such group on such December 31 unless all of such component members consent (at such time and in such manner as the Secretary or his delegate shall by regulations prescribe) to an apportionment plan providing for an unequal allocation of such amount. The amounts specified in paragraphs (2) and (3) shall be divided equally among the component members of such group on such December 31 unless the Secretary or his delegate prescribes regulations permitting an unequal allocation of such amounts.

* * * * *

IRC § 1562 [as added by Revenue Act of 1964, Pub. L. No. 88-272, Section 235(a), 78 Stat. 117. Repealed for taxable years beginning after December 31, 1974 by Tax Reform Act of 1969, Pub. L. No. 91-172, Section 401(a)(2), 83 Stat. 600]:

PRIVILEGE OF GROUPS TO ELECT MULTIPLE SURTAX EXEMPTIONS.

(a) *Election of Multiple Surtax Exemptions.*—

(1) *In general.* — A controlled group of corporations shall (subject to the provisions of this section) have the privilege of electing to have each of its component members make its returns without regard to section 1561. Such election shall be made with respect to a specified December 31 and shall be valid only if—

(A) each corporation which is a component member of such group on such December 31, and

(B) each other corporation which is a component member of such group on any succeeding December 31 before the day on which the election is filed,

consents to such election.

(2) *Years for which effective.* — An election by a controlled group of corporations under paragraph (1) shall be effective with respect to the taxable year of each component member of such group which includes the specified December 31, and each taxable year of each corporation which is a component member of such group (or a successor group) on a succeeding December 31 included within such taxable year, unless the election is terminated under subsection (c).

(3) *Effect of election.* — If an election by a controlled group of corporations under paragraph (1) is effective with respect to any taxable year of a corporation—

(A) section 1561 shall not apply to such corporation for such taxable year, but

(B) the additional tax imposed by subsection (b) shall apply to such corporation for such taxable year.

(b) *Additional Tax Imposed.*—

(1) [as amended by Sec. 401(b)(2)(A), Tax Reform Act of 1969, *supra*] *General rule.* — If an election under subsection (a)(1) by a controlled group of corporations is effective with respect to the taxable year of a corporation, there is hereby imposed for such taxable year on the taxable income of such corporation a tax equal to 6 percent of so much of such corporation's taxable income for such taxable year as does not exceed the amount of such corporation's surtax exemption for such taxable year. This paragraph shall not apply to the taxable year of a corporation if—

(A) such corporation is the only component member of such controlled group on the December 31 included in such corportation's

taxable year which has taxable income for a taxable year including such December 31, or

(B) such corporation's surtax exemption is disallowed for such taxable year under any provisions of this subtitle. . . ."

* * * * *

IRC § 1563(a) (2) [as added by Revenue Act of 1964, Pub. L. No. 88-272, Section 235(a), 78 Stat. 120. Effective for tax years ending before January 1, 1971 (current version at IRC § 1563(a)(2)]:

"(a)(2) Brother-Sister Controlled Group — Two or more corporations if stock possessing at least 80 percent of the total combined voting power of all classes of stock entitled to vote or at least 80 percent of the total value of shares of all classes of stock of each of the corporations is owned (within the meaning of subsection (d)(2)) by one person who is an individual, estate, or trust."

* * * * *

IRC § 1563(a)(2) [as added by Revenue Act of 1964, Pub. L. No. 88-272, Section 235(a), 78 Stat. 120, and amended by Tax Reform Act of 1969, Pub. L. No. 91-172, Section 401(c), 83 Stat. 602]:

DEFINITIONS AND SPECIAL RULES.

(a) *Controlled Group of Corporations.* — For purposes of this part, the term "controlled group of corporations" means any group of—

. . . . .

(2) [as amended by § 401(c), Tax Reform Act of 1969, *supra*] *Brother-Sister controlled group.* — Two or more corporations if 5 or fewer persons who are individuals, estates, or trusts own (within the meaning of subsection (d)(2)) stock possessing—

(A) at least 80 percent of the total combined voting power of all classes of stock entitled to vote or at least 80 percent of the total value of shares of all classes of the stock of each corporation, and

(B) more than 50 percent of the total combined voting power of all classes of stock entitled to vote or more than 50 percent of the total value of shares of all classes of stock of each corporation, taking into account the stock ownership of each such person only to the extent such stock ownership is identical with respect to each such corporation.

* * * * *

IRC § 1564(a) [as added by Tax Reform Act of 1969, Pub. L. No. 91-172, Section 401(b)(1), 83 Stat. 600]:

TRANSITIONAL RULES IN THE CASE OF CERTAIN CONTROLLED CORPORATIONS.

(a) LIMITATION OF ADDITIONAL BENEFITS.—

(1) *In general.* — With respect to any December 31 after 1969 and before 1975, the amount of—

(A) each additional $25,000 surtax exemption under section 1562 in excess of the first such exemption,

(B) each additional $100,000 amount under section 535(c)(2) and (3) in excess of the first such amount, and

(C) each additional $25,000 limitation on the small business deduction of life insurance companies under sections 804(a)(3) and 809(d)(10) in excess of the first such limitation,

otherwise allowed to the component members of a controlled group of corporations for their

taxable years which include such December 31 shall be reduced to the amount set forth in the following schedule:

Taxable years including—	Surtax exemption	Amount under sec. 535(c) (2) and (3)	Small business deduction limitation
Dec. 31, 1970	$20,833	$83,333	$20,833
Dec. 31, 1971	16,667	66,667	16,667
Dec. 31, 1972	12,500	50,000	12,500
Dec. 31, 1973	8,333	33,333	8,333
Dec. 31, 1974	4,167	16,667	4,167

(2) *Election.* — With respect to any December 31 after 1969 and before 1975, the component members of a controlled group of corporations shall elect (at such time and in such manner as the Secretary shall by regulations prescribe) which component member of such group shall be allowed for its taxable year which includes such December 31 the surtax exemption, the amount under section 535(c)(2) and (3), or the small business deduction limitation which is not reduced under paragraph (1)."

* * * * *

REGULATIONS INVOLVED:

Treas. Reg. § 1.1551-1(e)(1) and (3) (1967) (26 C.F.R.):

(e) *Meaning and application of the term "control"* — (1) *In general.* For purposes of this section, the term "control" means—

(i) With respect to a transferee corporation described in paragraph (a)(1) or (2) of this section, the ownership by the transferor corporation, its shareholders, or both, of stock possessing either *(a)* at least 80 percent of the total combined voting power of all classes of stock entitled to vote, or *(b)* at least 80 percent of the total value of shares of all classes of stock.

(ii) With respect to each corporation described in paragraph (a)(3) of this section, the ownership by five or fewer individuals of stock possessing (*a*) at least 80 percent of the total combined voting power of all classes of stock entitled to vote or at least 80 percent of the total value of shares of all classes of the stock of each corporation, and (*b*) more than 50 percent of the total combined voting power of all classes of stock entitled to vote or more than 50 percent of the total value of shares of all classes of stock of each corporation, taking into account the stock ownership of each such individual only to the extent such stock ownership is identical with respect to each such corporation.

* * * * *

(3) *Example.* This paragraph may be illustrated by the following example:

Example. On January 1, 1964, individual A, who owns 50 percent of the voting stock of corporation X, and individual B, who owns 30 percent of such voting stock, transfer property (other than money) to corporation Y (newly created for the purpose of acquiring such property) in exchange for all of Y's voting stock. After the transfer, A and B own the voting stock of corporations X and Y in the following proportions:

Individual	Corporation X	Corporation Y	Identical Ownership
A	50	30	30
B	30	50	30
Total	80	80	60

The transfer of property by A and B to corporation Y is a transfer described in paragraph (a)(3) of this section since (i) A and B own at least 80 percent of the voting stock of corporations X and Y, and (ii) taking into account each such individual's stock ownership only to the extent such ownership is

identical with respect to each such corporation, A and B own more than 50 percent of the voting stock of corporations X and Y.

* * * * *

Treas. Reg. § 1.1563-1(a)(1) and (3) (1965) (26 C.F.R.):

"Definition of controlled group of corporations and component members.

(a) Controlled group of corporations — (1) *In general.* For purposes of sections 1561 through 1563 and the regulations thereunder, the term 'controlled group of corporations' means any group of corporations which is either a 'parent-subsidiary controlled group' (as defined in subparagraph (2) of this paragraph), a 'brother-sister controlled group' (as defined in subparagraph (3) of this paragraph), a 'combined group' (as defined in subparagraph (4) of this paragraph) or an 'insurance group' (as defined in subparagraph (5) of this paragraph). For the exclusion of certain stock for purposes of applying the definitions contained in this paragraph, see section 1563(c) and § 1.1563-2.

. . . . .

(3) *Brother-sister controlled group.* (i) The term 'brother-sister controlled group' means two or more corporations if the same five or fewer persons who are individuals, estates, or trusts own (directly and with the application of the rules contained in paragraph (b) of § 1.1563-3), singly or in combination, stock possessing—

(a) At least 80 percent of the total combined voting power of all classes of stock entitled to vote or at least 80 percent of the total value of shares of all classes of the stock of each corporation; and

(b) More than 50 percent of the total

combined voting power of all classes of stock entitled to vote or more than 50 percent of the total value of shares of all classes of stock of each corporation, taking into account the stock ownership of each such person only to the extent such stock ownership is identical with respect to each such corporation.

(ii) The principles of this paragraph may be illustrated by the following examples:

Example (1). The outstanding stock of corporations P, Q, R, S, and T, which have only one class of stock outstanding, is owned by the following unrelated individuals:

	Corporations					Identical
Individuals	P	Q	R	S	T	Ownership
A	60%	60%	60%	60%	100%	60%
B	40%					
C		40%				
D			40%			
E				40%		
TOTAL	100%	100%	100%	100%	100%	60%

Corporations P, Q, R, S, and T are members of a brother-sister controlled group. . . ."